United States Court of Appeals

for the Second Circuit

PETITIONER'S BRIEF

76-4067

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 76-4067

Arthur Lipper Corporation and
Arthur Lipper III,

Petitioners,

v.

Securities and Exchange Commission

Respondent.

B P/S

Petition for Review of Orders of
Securities and Exchange Commission

BRIEF OF PETITIONERS

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PRELIMINARY STATEMENT

This case involves a securities firm conducting an institutional brokerage business during a period of extended controversy among the New York Stock Exchange ("NYSE"), institutional investors and the Securities and Exchange Commission ("SEC") involving such fundamental questions as justification for the very existence of the NYSE, and of particular relevancy here, the amount and manner in which its members were compensated. The SEC has candidly characterized this period as one of "debate, confusion and possibly conflicting views" in an Amicus Curiae brief recently filed with this Court.[1/]

Petitioners are Arthur Lipper Corporation, the securities brokerage firm, and Arthur Lipper III, its president and principal shareholder.

1/ Brief of the SEC, Amicus Curiae, (April 1976), filed in Tannenbaum v. Zeller, No. 75-7503. References to the Joint Appendix are cited as "A___." References to the record are cited as "Doc.__,R.__," indicating the document number and record page number in the Certified List of All Documents, etc. A 1-32.

Petitioners appeal from a decision by the SEC revoking the broker-dealer registration of Arthur Lipper Corporation and barring Mr. Lipper for life from the United States securities business. The complete and only charge: sharing brokerage commissions earned on over-the-counter securities transactions with another brokerage firm affiliated with the foreign customers' investment adviser, pursuant to the customers' instructions.

At the time of the transactions complained of, the sharing of commissions pursuant to customers' instructions was an accepted, widespread and customary practice of the securities industry. Brokers performing various services for institutional customers would receive portions of commissions on transactions which were either related or unrelated to the specific transaction services performed. The focal point of this industry-wide practice was the NYSE, the rules of which prescribed high minimum non-volume reduced, non-member commission rates which its members were required to charge. The NYSE would tolerate no rebates, direct or indirect, to members' customers. The NYSE drew a clear distinction between customers, who could not receive any rebates, and those directing the placement of orders for other than their own accounts. If qualified by membership in exchanges or the National Association of Securities Dealers ("NASD"), firms could be awarded, by the customer, a portion of the commission the customer was required to pay.

Commission-sharing practices, also known as "give-ups", were criticized by the SEC and its staff during this period and just as strongly defended by the NYSE and other self-regulatory bodies. No exchange nor the NASD required that any service of any nature be performed by the broker recipient of shared commissions. But it was not until December 5, 1968, after the

transactions in question had occurred, that commission-sharing practices were banned by the NYSE. Minimum commission rates, however, continued in effect until they also were abolished in 1975.

Hindsight tends to diminish the time span required to effect the abolition of minimum commission rates and commission-sharing arrangements, but the realities of operating under the minimum commission rate structure and commission-sharing practices at the time of the transactions in question, in 1967 and 1968, are the only standards by which to fairly judge the conduct of Petitioners.

QUESTIONS PRESENTED

(1) Whether a securities broker and its president and principal shareholder, acting in good faith, on the advice of well qualified counsel, and in accordance with industry practice, may be accused of aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder?

(2) Whether an unaffiliated United States securities broker has any duty or obligation to disclose to foreign shareholders of foreign investment companies the brokerage commissions charged by the broker or the sharing of commissions as directed by duly authorized representatives of the foreign companies?

(3) Is due process denied by an administrative agency when the agency supports its determination by staff studies and ignores the uncontradicted evidence in the record, fails to make a speedy determination, and rejects a Petition for Rehearing requesting oral argument because of the

agency's unexplained delay in reaching a determination?

STATUTE AND RULES INVOLVED

Section 10(b) of the Securities Exchange Act of 1934 states:

Regulation of the Use of Manipulative and Deceptive Devices

Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange --

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 thereunder states:

Rule 10b-5. Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Section 30(b) of the Securities Exchange Act of 1934 states:

Section 30(b) The provisions of this title or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title.

Article XV, Section 1 of the NYSE Constitution provided during the period in question:

Sec. 1. Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for the account of members or allied members or of parties not members or allied members of the Exchange, of securities admitted to dealings upon the Exchange and these commissions shall be at rates not less than the rates in this Article prescribed; and shall be net and free from any rebate, return, discount or allowance made in any shape or manner, or by any

method or arrangement direct or indirect. No bonus or percentage or portion of a commission, whether such commission be at or above the rates herein established, or any portion of a profit except as may be specifically permitted by the Constitution or a rule adopted by the Board of Governors shall be given, paid or allowed, directly or indirectly, or as a salary or portion of a salary, to a clerk or person for business sought or procured for any member or allied member of the Exchange or member firm or member corporation. [No member, member firm or member corporation shall, in consideration of the receipt of listed business and at the direct or indirect request of a non-member or by direct or indirect arrangement with a non-member, make payment or give up any work or give up all or any part of any commission or other property to which such member, member firm or member corporation is or will be entitled.]

Bracketed portion added by Amendment dated December 5, 1968.

STATEMENT OF THE CASE

By order dated October 24, 1975, the SEC revoked Arthur Lipper Corporation's broker-dealer registration and permanently barred Arthur Lipper III from association with any broker or dealer. These sanctions were based upon findings that:

(1) IOS Ltd, the Geneva-based, Panama incorporated investment manager of a complex of foreign investment companies, breached its fiduciary duty toward these foreign companies and their foreign shareholders in violation of Section 10(b) of the Exchange Act and

Rule 10b-5 thereunder as a consequence of brokerage commission-sharing arrangements. (A 433-34)

(2) Arthur Lipper Corporation and Arthur Lipper III were necessary participants in the breach of trust and hence "aided and abetted the IOS respondents' violations." (A 434)

By order dated January 6, 1976, the SEC denied Petitioners' Petition for Rehearing made on the ground that Petitioners were not afforded a true oral argument as required by the SEC's own rules since, of the four SEC Commissioners who decided the case, only one was in office and sitting when, three years previously, counsel was permitted to argue orally. In other words, the SEC failed to reach a timely determination and a majority of those Commissioners who decided this case did not hear oral argument.

Who Are the Petitioners?

Arthur Lipper Corporation was organized in April 1967 to engage primarily in the institutional brokerage business. It registered with the SEC as a broker-dealer and an investment adviser and became a member of the NYSE, the American Stock Exchange, various regional stock exchanges and the NASD. (A 427)

Arthur Lipper III is the founder, controlling stockholder and chief executive officer of Arthur Lipper Corporation. Mr. Lipper had spent 16 years in the securities business; 12 of these years had been spent in the institutional brokerage business. (A 150-52) Immediately prior to establishing Arthur Lipper Corporation, Mr. Lipper was a partner of Zuckerman, Smith & Company, a NYSE member. (A 152)

<u>What Was the Petitioners' Relationship with IOS?</u>

IOS was a holding corporation controlling a financial complex of companies that engaged, among other things, in rendering investment advice to foreign investment companies and in distributing the shares of such companies throughout the free world. (A 428-31) The foreign investment companies involved in this proceeding, The Fund of Funds, Limited ("F.O.F."), IIT, an International Investment Trust ("IIT"), and Regent Fund, Ltd. ("Regent"), will be herein referred to collectively as the "foreign investment companies".[1/]

As part of a settlement of certain SEC proceedings instituted against IOS in February, 1966, the foreign investment companies were required to place orders to buy and sell securities traded in the U. S. securities markets either with a foreign branch office of a U. S. broker-dealer or with non-U. S. broker-dealers; they were precluded from dealing directly with brokers in the United States by the settlement order. In early 1967, IOS approached Mr. Lipper, the partner in the firm of Zuckerman, Smith & Company who was in charge of handling the firm's institutional accounts and therefore those associated with IOS, and asked whether Zuckerman, Smith would be in-

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1/ F.O.F., IIT and Regent are not only literally foreign investment companies in terms of their respective incorporations and historical activities, but also by paragraph 4 of the IOS Settlement Order, May 23, 1967 (A 368-77), they were required to "cease all sales of securities to United States citizens or nationals wherever located." By paragraph 8 IOS was required to offer the equivalent of rescission to nearly all United States citizens who had purchased F.O.F. shares.

terested in opening foreign offices to serve the IOS business when the then pending settlement with the SEC became effective. When the partners of Zuckerman, Smith declined the proposal, Mr. Lipper decided to retire as a partner of that firm and organize a new NYSE member firm with overseas offices to service the IOS affiliated accounts. Accordingly Mr. Lipper made a sizeable capital investment and established Arthur Lipper Corporation with offices in New York, London and Geneva and an elaborate communications network which could be used to execute transactions for the foreign investment companies in the U. S. securities markets in compliance with the anticipated terms of the IOS Settlement Order. (A 51-53; 158-62)

What Is A Customer Directed Give-Up?

A "customer directed give-up" is a sharing of a portion of the commission received by the executing broker with another broker designated by the executing broker's customer.

What Was Petitioners' Role in the Customer Directed Commission-Sharing Arrangements?

When it began to execute transactions on behalf of the foreign investment companies, Arthur Lipper Corporation received instructions, confirmed in writing from each of the funds, to share (i.e., give-up) 50% of the commissions earned on over-the-counter transactions with Investors Planning Corporation ("IPC"), a U. S. registered broker-dealer and a member of the NASD. These instructions to Arthur Lipper Corporation, maintained openly in its files at all times available for examination by the SEC Staff, were issued by Edward M. Cowett, an officer and/or director of each of the

foreign investment companies and a recognized securities law attorney who had co-authored a securities law reference book with Professor Louis Loss. The foreign funds, not IOS, were the customers of Arthur Lipper Corporation. Arthur Lipper Corporation followed its customers' instructions, and during the period April 30, 1967 to August 30, 1968, Arthur Lipper Corporation shared with IPC approximately $1,450,000 of approximately $2,666,000 total over-the-counter commissions earned during the period. Payments from Arthur Lipper Corporation to IPC were made by monthly checks, accompanied by confirming correspondence and recorded openly and meticulously on Arthur Lipper Corporation's books. (A 433; 169-73; Docs. 10-15, R. 1655-1660)

Why Did Its Customers Direct Arthur Lipper Corporation To Share Commissions With IPC?

Two years before Arthur Lipper Corporation was established, IOS acquired IPC intending IPC to be the IOS subsidiary which would sell U. S. SEC registered mutual fund shares in the United States. Upon the acquisition of IPC, and prior to the IOS Settlement Order requiring IOS to dispose of its entire interest in IPC, the managements of IOS and IPC began to explore various techniques whereby IPC could participate fully in the reciprocal brokerage practices which were then prevalent in the U. S. mutual fund industry. Three sources of reciprocal brokerage business were available: (1) transactions on behalf of the IOS related foreign investment companies, (2) transactions on behalf of Fund of America, a United States SEC registered investment company for which a subsidiary of IPC served as investment adviser

and the shares of which IPC and IOS distributed,[1/] and (3) transactions on behalf of other United States registered investment companies whose shares IPC distributed to the public, either directly in IPC's capacity as a dealer or indirectly in IPC's capacity as a sponsor of unit investment trusts. Since IPC was a member of the NASD, IPC was eligible under NASD regulations to share commissions on transactions effected on certain of the U. S. regional exchanges, the rules of which permitted members to share commissions with members of the NASD, and transactions effected in the over-the-counter market. (A 70-71, 61-65) Hence IPC, as an NASD member, was the only entity in the IOS complex which was "eligible" to receive give-up payments on over-the-counter transactions under the then prevailing rules of the various self-regulatory bodies.

Did Petitioners Consult with Counsel?

Mr. Lipper, who was aware that IOS and its foreign funds were controversial because of the extended IOS litigation with the SEC, retained the Wall Street firm of Willkie Farr & Gallagher as counsel for Arthur Lipper Corporation in order to insure compliance with all applicable rules and regulations, as well as the IOS settlement order. The partner in charge was Allan F. Conwill, a former general counsel and director of the Investment Company Division of the SEC. He was particularly well qualified for this

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1/ No over-the-counter give-ups of Fund of America or any other United States registered investment company are at issue as to these Petitioners. The commission-sharing arose only from transactions executed on behalf of the foreign investment companies.

role, aside from his expertise as a securities law attorney, because his firm had represented IOS in connection with the IOS settlement order and was fully familiar with its complicated provisions and background.

What was Counsel's Advice?

With respect to the brokerage rates charged by Arthur Lipper Corporation, Mr. Lipper was advised by Mr. Conwill, who had consulted with officials of the NYSE, to charge minimum NYSE commission rates on all transactions for the foreign investment companies, regardless of whether the transactions were effected on the NYSE or effected in the over-the-counter market. The reason Mr. Conwill advised that NYSE minimum commission rates had to be charged on over-the-counter transactions was because Arthur Lipper Corporation would risk possible expulsion or other disciplinary action by the NYSE if it were to engage in over-the-counter commission reductions for the same customers for whom it executed NYSE transactions. Arthur Lipper Corporation, as a member of the NYSE, could not subject itself to a charge of making illegal rebates to customers on NYSE commission business. The rebating of NYSE commissions, directly or indirectly, was a matter which the NYSE dealt with severely. And while the NYSE purportedly had no authority with respect to over-the-counter transactions, in practice it did so in an effective way - by requiring its members to justify that they were covering their full related costs whenever they charged less than NYSE rates - an almost impossible task intended to convey the "message" that in reality possible justification of lesser charges was an effort which the NYSE did not wish its members to make.

Why Did the SEC Consider the Commission-Sharing Arrangements Fraudulent?

The Commission believed that IOS could and should have negotiated a 50% reduction in commissions rather than directing a 50% give-up to IPC. (A 437) In other words, at the direction of Mr. Cowett, an officer of each of the foreign investment companies, Arthur Lipper Corporation charged its foreign customers more than the SEC assumed could have been negotiated by Mr. Cowett on their behalf.

What is Petitioners' Position?

In the circumstances here, Arthur Lipper Corporation, as a NYSE member, charged all its customers, including the foreign investment companies, minimum NYSE standard commission rates on over-the-counter transactions because to charge less would have exposed Arthur Lipper Corporation to possible expulsion or other disciplinary action by the NYSE for making illegal rebates to customers on NYSE commission business. Neither Arthur Lipper Corporation nor any other member of the NYSE was willing to assume such risk of disciplinary action in charging less than minimum NYSE rates on over-the-counter transactions. All NYSE members universally followed the practice of charging the NYSE minimum rates. Hence, Mr. Cowett <u>could not</u> possibly have negotiated lower rates with Arthur Lipper Corporation <u>or any other member of the NYSE</u>.[1/] Under the circumstances, the business decision of

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1/ Moreover, the IOS settlement order precluded Cowett or any other IOS affiliates from contacting an over-the-counter market maker or contracting with any other broker-dealer in the United States directly. (A 438)

Arthur Lipper Corporation not to jeopardize the vital NYSE membership which was the very cornerstone of its business, was not unreasonable. (A 435)

Did Other NYSE Members Share Commissions On Over-the-Counter Transactions?

Yes. The record demonstrates that the following brokers followed the instructions of the IOS related funds and, like Arthur Lipper Corporation, shared commissions with IPC on over-the-counter transactions: Ladenberg, Thalmann & Company (Doc. 88, R. 1827-1828); Glore, Forgan & Staats, Inc. (A 142-44; Docs. 185-187, R. 2413-21); Adams & Peck (Doc. 109, R. 1869); Bear, Stearns (Doc. 111, R. 1871); Emmanuel Deetjen & Co. (Doc. 112, R. 1872); Jessup & Lamont (Doc. 113, R. 1873); Drexel, Harriman & Ripley (Doc. 114, R. 1874); George Robinson & Co. (Doc. 116, R. 1876); Baker, Weeks & Co. (Doc. 124, R. 1896); Hertz, Warner & Co. (Docs. 41-46, R. 1780-1785); Hertzfeld & Stern (A 35-36; Doc. 92, R. 1833); and White, Weld & Co. (Doc. 130, R. 1902). The NYSE was aware of the practice followed by its members of sharing over-the-counter commissions with NASD members, and did not disapprove of the practice. (A 388) There is no evidence in the record that any firm, exchange or self-regulatory body considered the practice improper.

ARGUMENT

I. PETITIONERS DID NOT AID AND ABET VIOLATIONS OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 THEREUNDER BECAUSE THEY ACTED IN GOOD FAITH, ON THE ADVICE OF WELL QUALIFIED COUNSEL, AND IN ACCORDANCE WITH THEN EXISTING INDUSTRY PRACTICE.

Petitioners had no reason to believe that their routine and fully disclosed commission-sharing arrangements at the direction of their foreign customers would some day be alleged to be fraudulent. Indeed, Petitioners were acting on the advice of a former general counsel and director of the Investment Company Division of the SEC, and in accordance with accepted industry practice. Counsel consulted with officials of the NYSE and learned that NYSE members charged NYSE rates in executing over-the-counter transactions. For the Petitioners to uniquely charge less would have been improper. Petitioners were concerned that any reduction in commissions below the NYSE minimum rates on over-the-counter transactions could subject them to loss of their NYSE membership. They had no reason to depart from the accepted and customary practice of all NYSE members who charged NYSE minimum rates on over-the-counter agency transactions.

Certainly Petitioners were willing to and did negotiate a smaller retained commission; but the negotiation followed the accepted form of negotiation followed by all members of the NYSE both on exchange transactions

and on over-the-counter transactions, namely a commission-sharing arrangement. Moreover, had Arthur Lipper Corporation retained the whole commission or had the transactions occurred on any exchange and the commission shared with any other exchange member, there would have been no charge of fraud.

The SEC theorizes that, nevertheless, IOS could have negotiated a 50% reduction in the minimum NYSE commission rate. But if a U. S. broker were to agree to a 50% reduction in the over-the-counter commission rate charged by all other members of the NYSE and the reduction were at the request of customers for whom it transacts a substantial amount of NYSE business, a rebate would clearly be involved; to urge otherwise is to ignore the practical economic and regulatory realities of the period. Article XV, Section 1 of the NYSE Constitution (pages 5-6, supra) provided that commissions "...shall be net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement direct or indirect."

What the SEC is saying is that Arthur Lipper Corporation should have been willing to rebate to its customers half of its commissions. Arthur Lipper Corporation, as a NYSE member, could not jeopardize its NYSE membership, the very cornerstone of its business, by departing from the customary industry practice, especially when older, larger and more established NYSE member firms chose not to do so. These firms are listed supra at page 14. There is no evidence in the record that the Petitioners acted other than in the utmost good faith in this regard. Certainly, they were not required to play the Quixotic role now demanded of them in hindsight by the SEC to challenge the NYSE and its regulations. The SEC had at all times

the rule-making ability to ban any and all forms of commission-sharing arrangements and yet consistently failed to exercise this authority.

The SEC's error is manifest from two inconsistent statements in its opinion. The SEC first flatly states, "The New York Stock Exchange had no jurisdiction over commission rates in the over-the-counter transactions." (A 435) In so finding, the SEC chose to ignore the factual question clearly presented by the record: Did the NYSE exercise de facto authority over rates charged on over-the-counter transactions by its members? The wrongness of the SEC's "jurisdictional" finding is suggested by the SEC's own statement on the next page of its opinion in footnote 33: "The New York Stock Exchange official previously referred to did testify that very low over-the-counter charges might in certain circumstances be deemed impermissible rebates". (A 436) 1/ This second SEC statement at a minimum suggests that the NYSE had some interest in what its members charged in the over-the-counter market.

For a clear picture of the NYSE position we respectfully refer this Court to read the relevant testimony of Mr. Bishop, Vice President of the NYSE, and Allan F. Conwill of Willkie Farr & Gallagher, counsel to Petitioners who consulted with NYSE officials, and SEC Division's Ex 78,

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1/ Moreover, this reluctant footnote concession of the SEC does not square with another flat statement of the SEC that "The New York Stock Exchange's anti-rebate policies are clearly not relevant here. Those policies applied only to transactions on that exchange". (A 435) The SEC's broad statements, of course, are either wishful speculation of what the NYSE policies should have been or, as we suspect, attempted justification of earlier statements in staff reports which purportedly described the over-the-counter markets generally without reference to activities therein by NYSE members. The SEC ultimately does concede that Petitioners "point to the fact that it was the usual practice in agency transactions in over-the-counter market to charge the New York Stock Exchange commission rates" and says "This appears to be correct", citing its own staff's study. (A 438)

entitled "Across the President's Desk, A Periodic Report to the Exchange Community from G. Keith Funston" (then NYSE President) set forth in the Joint Appendix at pages 383-97; 238-44; 273-75; 278-80; 323-25; 330-32. Mr. Bishop made it quite clear that unless a NYSE member followed the minimum NYSE standard commission rate in the over-the-counter market, the member would be exposed to a charge by the NYSE that the member, through cut-rate non-NYSE commission charges, was rebating commissions earned on exchange transactions executed for the same customer.

Mr. Bishop testified (A 330-31):

Q. Mr. Bishop, I believe you have testified in answer to one of Mr. La Prade's questions that if a member of the New York Stock Exchange charged less than the New York Stock Exchange standard commission in the over-the-counter market, that this could be deemed rebative, a rebate; is that correct?

A. It might be.

Q. And I believe you put it in terms of less than the going rate or the usual commission.

Do you recall that?

A. Perhaps I used that phrase, but I thought I said less than cost or the going rate; something of that nature.

The cost is the important part.

Q. What would the going rate refer to, sir?

A. Whatever the firm ordinarily charged on its over-the-counter trades.

Q. Well, with respect to New York Stock Exchange members, is it not a fact that as a matter of practice agency transactions in the over-the-counter market by and large had the New York commission rate applied to them as far as the public concerned.

A. That's my understanding.

The basis of the NYSE's position was explained by Mr. Conwill, counsel for Arthur Lipper Corporation, when he testified regarding his conversation with Mr. Bishop when Arthur Lipper Corporation was applying for membership with the NYSE. Mr. Conwill said (A 274):

> Q. Mr. Bishop of the New York Stock Exchange?
>
> A. It could have been Mr. Schiowitz, but I'm quite sure it was Mr. Bishop. He told me, by saying that if we charged anything other than the minimum rate, we would have to justify it, because from his point of view, and I do remember this conversation, if you had--<u>if you were required to make a given charge on executing a New York Stock Exchange listed security, it was presumably just as difficult to make an execution in the over-the-counter market, and therefore, the same charge was appropriate</u>. (emphasis added)

The best evidence of the attitude of the NYSE prevailing in 1967 regarding give-ups in the over-the counter market appears from the publication of the NYSE introduced in evidence at the hearing by the SEC staff (A 383-97) "Across the President's Desk", February 1, 1967). This 1967 document is an extensive report by G. Keith Funston, then President of the NYSE, to members on give-up practices in the industry. On page 4 under the caption, "Give-Ups to Non-Members," Mr. Funston noted that pressure from institutional customers had brought about arrangements whereby give-ups were directed to securities firms which were non-members of the NYSE. He stated "these arrangements are based on transactions on regional exchanges or <u>over</u>-<u>the</u>-<u>counter</u> but they are frequently made possible by NYSE commission dollars" (emphasis added) (A 386-87). On page 6 of the same report Mr. Funston again discussed over-the-counter give-ups:

> A similar practice has arisen in the over-the-counter market. Some member firms keep a running total of commissions earned on over-the-counter trades, and give-up 50% of those commissions to NASD members at the direction of institutional customers. As before, the customers for whom the trades are effected do not know their commissions are being used in this way.1/

Finally, the chart on page 8 of the report graphically demonstrates give-ups in the over-the-counter market were being made to NASD members. In the face of the SEC Division's own exhibit, which is conspiciously absent of criticism by the NYSE of over-the-counter give-up arrangements, we urge this Court to hold that the SEC's findings are clearly erroneous.

Arthur Lipper Corporation, like other members of the NYSE during the period in question, was willing to execute transactions on the NYSE for its institutional customers and retain 50% or less of the commissions charged. No NYSE member, however, could charge its customer less than the NYSE minimum commission without violating the anti-rebate prohibition of Article XV of the NYSE Constitution. Likewise, Arthur Lipper Corporation and other members of the NYSE were willing to execute over-the-counter transactions and retain 50% or less of the commissions charged; however, neither Arthur Lipper Corporation nor any other member of the NYSE was "willing" to charge its customers less than the minimum NYSE rates because of the NYSE's anti-rebate prohibition. Although over-the-counter transactions are not

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1/ As we have stressed in the instant case the customer not only knew of the give-ups, but, in fact, issued written instructions to share the commissions.

ostensibly regulated by the NYSE, the NYSE's interest in preserving the sanctity of the anti-rebate prohibition led it to pursue the policy of requiring its members firms to justify that they were meeting their costs whenever they charged less than the minimum NYSE rates for executing over-the-counter transactions. There is no evidence in the record that any NYSE member ever charged anything other than NYSE minimum rates or could even have justified lower charges to the satisfaction of the NYSE should it have been so disposed.

Arthur Lipper Corporation, like other members of the NYSE, was willing to "negotiate" commission rates, but such negotiation was always conducted within the confines of industry practice accepted by the NYSE; i.e. negotiation was permitted as to amount retained but not as to amount charged. Thus, Arthur Lipper Corporation, as well as the twelve other NYSE members described in the record as having executed transactions for the foreign investment companies, (1) charged the NYSE rate to execute over-the-counter transactions and (2) retained less than the NYSE rate after accepting and acting upon customer "give-up" instructions. The threat of disciplinary action by the NYSE was sufficient to deter any firm from deviating from the NYSE rate structure. Yet, because commission-sharing among brokers was a common industry practice accepted by the NYSE, no firm refused to honor customer give-up instructions.

Therefore, good reasons existed why Arthur Lipper Corporation and other NYSE members were not willing to "negotiate" on the NYSE rate charged customers on both NYSE and over-the-counter transactions, but were willing to negotiate as to the amount of commissions which they would actually retain in accordance with industry practice. Neither Arthur Lipper

Corporation nor any other NYSE member can be said to have participated in a fraudulent scheme for following what they believed was the accepted and safer practice during the period in question: i.e., charge the NYSE minimum rate and give up commissions to other members of the brokerage community, but not give back a portion of the commissions to the customers.

The record demonstrates that the following brokers followed instructions of the IOS related funds and, like Arthur Lipper Corporation, shared commissions on over-the-counter transactions. Ladenberg, Thalmann & Company; Glore, Forgan & Staats, Inc.; Adams & Peck; Bear, Stearns; Emmanuel Deetjen & Co.; Jessup & Lamont; Drexel, Harriman & Ripley; George Robinson & Co.; Baker, Weeks & Co.; Hertz, Warner & Co.; Hertzfeld & Stern; and White, Weld & Co. The NYSE was aware of the practice followed by its members of sharing over-the-counter commissions with NASD members, but did not disapprove of the practice. (A 388, 390) There is no evidence in the record that any firm, exchange or self-regulatory body considered the practice improper.

In this context, Arthur Lipper Corporation and Mr. Lipper should not have been charged with violations of Section 10(b) of the Exchange Act and Rule 10b-5. The Supreme Court has recently held that "scienter", an intent to [illegible]ive, manipulate, or defraud, is a necessary element of violations of Section 10(b) and Rule 10b-5. Ernst & Ernst v. Hochfelder, U.S. (1976). In reaching this decision the Court said, after

reviewing the legislative and administrative history of the Section and Rule, "There is no indication that Congress intended anyone to be made liable for such [illicit] practices unless he acted other than in good faith." Ernst & Ernst, supra.

Having had good reasons to charge NYSE rates on over-the-counter transactions and for refusing to reduce those rates or share commissions on a basis that could subject them to NYSE disciplinary proceedings, Petitioners, who consulted competent counsel, cannot be found to have acted in bad faith. They indeed had a reasonable basis for charging NYSE rates for over-the-counter transactions and for sharing commissions only with qualified persons in the U. S. broker-dealer community.

The reliance by Petitioners upon the advice of well-qualified counsel is an important factor in considering their good faith. In United States v. Crosby, 294 F.2d 928 (2nd Cir. 1961), cert. denied 368 U.S. 984 (1962), a case involving wire fraud, mail fraud and the sale of unregistered securities, this Court reversed the convictions and dismissed the indictments of a broker-dealer and its shareholders because the evidence was insufficient to establish the willful and knowing sale of unregistered securities. In that case the broker defendants relied upon the advice of counsel that the securities were exempt from registration. It is noteworthy to mention that the counsel upon whom they relied was himself convicted of participation in the fraudulent transactions alleged.

The Court's language in Crosby provides a standard by which the conduct of the Petitioners herein should be judged and is worthwhile quoting (294 F2d at 942-943):

> ...we cannot say that on its face the legal opinions tendered were so patently erroneous as to permit the jury to speculate on the good faith of the defendants.

It is always a difficult task in a complicated omnibus conspiracy case like this one to decide at what point the government has produced enough evidence against individual defendants to put their fates in the hands of the jury. Because of the tremendous potential for collateral prejudice inherent in these cases, however, the courts must be extremely scrupulous in sorting out the evidence against single defendants and weighing the same--divorced from the all too often damning influence of the background conspiracy. The case against these three defendants presents a peculiarly difficult problem in this regard because the prime issue is one of guilty knowledge and criminal intent. It is undisputed that the brokers' acts in fact furthered the conspiracy; the claim is persuasively made, however, that they were merely "doing business as usual" and, to their best knowledge, according to acceptable standards of that business. The statutory and administrative regulatory scheme over this area is far from a model of clarity; such a situation is aggravated when, as here, criminal liability is based on the failure to comply with the law. We think it is all too facile an answer for the government to rely on the experience and supposed expertise of these brokers; the fact is that they purported to rely on opinion letters of an attorney, whose expertise is presumed to be even greater. The scanty extrinsic evidence produced by the government against these defendants implies guilt only if we first assume guilty knowledge and purpose; when used to prove that basic element of the crime it is neither substantial nor convincing. The trial court erred in not directing a verdict of acquittal on all counts for defendants Gordon, Goldberg, Reicher, and Philip Gordon & Co., Inc.

Scienter had been required in Section 10(b) and Rule 10b-5 cases in this Circuit even prior to the decision of the Supreme Court in Ernst & Ernst, supra. Shemtob v. Shearson Hammill & Co., 448 F.2d 442 (2d Cir. 1971), and the cases cited therein. While the words used in Shemtob ("...Allegation of facts amounting to scienter, intent to defraud, wreckless disregard for the truth or knowing use of a device, scheme or artifice to defraud." 448 F.2d at 445) are broader than the words used by the Supreme Court in Ernst & Ernst ("...allegation of "scienter"--intent to deceive, manipulate or defraud." (U.S.), they both implicitly incorporate a good faith standard, i.e., that Section 10(b) and Rule 10b-5 may not be violated by a person acting in good faith. Here, where there is no evidence whatsoever that Petitioners acted other than in good faith, the decision of the SEC should be reversed.

II. THE COMMISSION-SHARING ARRANGEMENTS SHOULD BE REVIEWED IN HISTORICAL PERSPECTIVE

Customer directed commission-sharing arrangements began to pervade the securities industry in the early 1960's as an adjunct to the growth of large scale commissions generated by rapidly growing and increasingly aggressive institutional investors. The practice of institutional customers instructing their executing brokers to share commissions with other brokers became a convenient method by which the customer could centralize the execution function, while at the same time spread brokerage business to many. The NYSE best summarized its position on give-up practices when it stated:

> <u>...give-ups are a most efficient and economical means of enabling substantial investors to meet their obligations, as they see them, to many brokers.</u> 1/ (emphasis in original)

Thus, the NYSE never objected to commission-sharing in the various securities markets, including the over-the-counter market, provided the commissions were shared with "eligible persons". 2/ To the NYSE and other self-regulatory bodies "eligible persons" were limited to members of the brokerage community who were not required to have performed any services or provided any benefits to the customer. Customers, especially institutional customers, were specifically not "eligible"; for if a customer received a give-up, the member of the NYSE would have given the customer a rebate in violation of the most fundamental rule of the NYSE -- members must charge their customers the minimum NYSE standard commission rate. 3/ Only the ability to transact business at a member's preferential rate and the obligation to charge all non-members a uniform higher rate justified the existence of an exchange and made membership desirable.

1/ Comment of the NYSE on SEC's proposed Rule 10b-10, <u>Selected Comments on SEC Proposed Rule on Give-Ups</u>, CCH, P. 47 (1968).

2/ There is absolutely no basis for the SEC's erroneous and misleading statement that "[i]f the New York Stock Exchange's rules had been applicable to these transactions, they would have prohibited commission-splitting with IPC as well as with the funds that paid those commissions" (A 436). While commissions on NYSE transactions could only be split with NYSE members, Petitioners have established that the interest of the NYSE in over-the-counter transactions was directed at rebates on NYSE business to the same customers in other markets, including the over-the-counter market. The NYSE did not object to commission-sharing with another broker which, like IPC, was not the customer in whose account the transaction occurred.

3/ Article XV of the NYSE Constitution. See pp. 5-6, *supra*.

Since in a give-up arrangement the executing broker was apparently content to perform his functions and retain normally only 50% (although sometimes as little as 20%) of the commission, the SEC began to question whether such arrangements were, in fact, "most efficient and economical". In its 1962 Report of Special Study of Securities Markets ("Special Study"), give-up practices were examined by the SEC staff in the context of determining the soundness of the securities industry's defense of the minimum commission rate structure. The maintenance of such a structure while in practice the executing broker was giving away 50% of the commission seemed incongruous. The staff recommended a further study of give-up practices generally and specifically recommended that the NASD adopt a rule banning give-ups on over-the-counter transactions and that the SEC issue a Statement of Policy condemning the practice. Special Study. Pt. 4, Ch XI, p. 235. In its recommendation, the staff assumed that the minimum rate structure of the NYSE had no application in the over-the-counter markets and therefore a give-up might inevitably result in an overcharge to the customer. The NASD did nothing; the SEC did nothing; give-up practices continued, and in fact became more widespread.[1/]

In July 1966, the Director of the SEC's Division of Trading and Markets wrote to the various self-regulatory bodies, including the NASD and the NYSE, attacking give-up practices in general and condemning in

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1/ The SEC implemented many of the Special Study recommendations and, at the direction of the House Interstate and Foreign Commerce Committee, reported those recommendations which it had or intended to implement. It never adopted the recommendation to issue a Statement of Policy against over-the-counter give-ups or otherwise used its ample rule making power to ban such give-ups. Under the circumstances it is reasonable to suggest that the nunc pro tunc proceedings against these Petitioners bear more than a slight element of ex post facto.

particular over-the-counter give-up practices. This letter was introduced into the record in this proceeding.[1/] The responses of the NASD and the NYSE to the letter, if indeed there were any, were not put into the record. Whatever evidentiary value the letter might have, it did not focus upon the factual situation presented in this case and confronted by Mr. Lipper as a businessman -- over-the-counter transactions and commission sharing by NYSE members. In any event, the self-regulatory bodies did nothing -- the SEC did nothing.[2/]

In late 1966 the SEC published its Mutual Fund Study.[3/] Again give-up practices were criticized, including over-the-counter give-up practices. Again, the self-regulatory bodies did nothing; the SEC did nothing.

1/ Division's Exhibit No. 47. (A 378-82)

2/ On October 11, 1967, in testimony before the House Subcommittee on Commerce and Finance in response to a question by Congressman Moss whether the SEC had "authority to direct that give-ups accrue to the benefit of the fund and its shareholders?", then Chairman Cohen answered "I have some doubt in the framework in which you have put it, but I don't want to give a definite yes or no answer." (emphasis added) Hearings, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce. H.R. 9510 and 9511, House of Representatives, 90th Congress First Session, pp. 209-210. If the then SEC chairman doubted the SEC's authority at the very time the give-ups here at issue were occurring, does it not border on the absurd for the SEC to contend that Arthur Lipper Corporation in effect should have initiated action which the SEC chairman doubted that the SEC itself should or could compel.

3/ Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, Committee on Interstate and Foreign Commerce, House of Representatives, 89th Cong., 2d Sess., House Report No. 2337 (1966).

Then, in January 1968, the SEC published for public comment proposed Rule 10b-10.[1/] In an extensive statement accompanying the proposed Rule, the SEC made clear the action it was finally prepared to take on give-up practices; proposed Rule 10b-10 did not ban give-ups, but instead was designed to take advantage of the practice for the benefit (as the SEC saw it) of the shareholders of institutional customers. Thus, under the proposed Rule, affiliated persons of a mutual fund would have committed a fraud unless they instructed the executing broker to give-up to the affiliated person who, in turn, would be required to offset the give-up payment it received against advisory or other fees it charged the mutual fund. In short, the SEC was proposing to require that a rebate be made to the institutional customer. But unless the executing broker was also an affiliated person of the mutual fund, the broker would not have had any obligations under the Rule.

The intended result of proposed Rule 10b-10 can best be illustrated as follows: Arthur Lipper Corporation did exactly what was contemplated by proposed Rule 10b-10 -- it followed its customers' instructions to return part of the commission to an affiliated person. Had the proposed Rule been in effect, it would have been the duty of the affiliated person -- through probably not foreign broker-dealers such as IOS, the parent of IPC -- to offset its advisory or underwriting fees by the amount of the give-up payment.

1/ Securities Exchange Act Release No. 8239, January 26, 1968.

Prior to 1968, the rationale for the SEC's specific criticism of over-the-counter give-ups was that give-up arrangements could only be defended where a fixed rate is in effect, e.g., on NYSE transactions. Since the SEC erroneously assumed that there was no de facto fixed rate applicable to over-the-counter transactions, the SEC also assumed that the brokers and their customers were free to negotiate the commission fee. But this negotiated market position of the SEC was modified when, in proposing Rule 10b-10 and in its explanation thereof, the SEC stated that on NYSE transactions "[g]ive-ups and reciprocal business practices in connection with institutional trading have become so wide-spread that it may plausibly be argued that, in the case of large institutional orders, there is in economic substance no fixed minimum commission" and that "[c]ommissions are negotiated between institutional managers and their 'lead' brokers with the lead broker on occasion retaining no more than 25 percent of the ostensible minimum commission." (emphasis added) Securities Exchange Act Release No. 8239, p. 4. In short, by 1968 the SEC's position was that give-ups were not to be deemed unlawful even where the commission may be negotiated, provided the conditions of proposed Rule 10b-10 were met, namely, the fund adviser offset the give-up payments received against its advisory or other fees. By January 1968, when proposed Rule 10b-10 was published for comment, the SEC had apparently concluded that there were to be "good" give-ups and "bad" give-ups.

The comments on proposed Rule 10b-10 were extensive; many were highly adverse. Then, in December 1968, almost a year after the Rule was first proposed, the NYSE elected to follow that which it believed to be the better, for its members, of two unattractive courses of action: the NYSE banned give-ups rather than accept a rule involving rebates to NYSE member firms' institutional customers. The SEC withdrew proposed Rule 10b-10.

In 1969, nine months after give-up practices were banned, the SEC instituted this proceeding challenging give-up arrangements occurring in 1967 and 1968. The charge manufactured is a violation of Rule 10b-5.

The foregoing chronology is the accurate framework against which to measure the conduct of Arthur Lipper Corporation in this case. Arthur Lipper Corporation was established in early 1967. At that time give-up arrangements were widespread in the securities industry; the SEC and its staff had criticized industry give-up practices, but had taken no official direct action to implement their concern though the SEC had such power.

The foregoing history, we submit, is consistent and in agreement with the SEC's own version of this time span set forth at pages 10-18 of the Brief of the Securities and Exchange Commission, Amicus Curiae, (April 1976) filed with this Court in Tannenbaum v. Zeller, No. 75-7503.[1/] There the SEC candidly characterized the "Regulatory Environment" as one of "debate, confusion and possibly conflicting views" (SEC Brief p. 15). In obvious anticipation of this litigation the SEC did "wish to stress that the mere fact that there is uncertainty in a particular area does not

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1/ For the Court's convenience we have reproduced relevant pages from the Commission's brief in an appendix to our brief. See, infra.

mean that liability can be avoided on the basis of an exercise of discretion of the board of directors" (SEC Brief p. 36, fn 46) citing its decision in this case. Essentially the SEC's position now seems to be that, with full disclosure to a truly independent board of directors, an investment company's brokerage commissions could have been used by the investment adviser to promote new sales of investment company shares and for research, but not retained in cash. The apparent economic thesis of the SEC is very naive-- the adviser may lawfully derive the economic benefit of a higher advisory fee (sales fees, custodial fees, directable commission business, float income) from increased mutual fund sales and the economic benefit of subsidized investment research. Why is cash in the hand an unlawful economic benefit as a truly different form of incremental income from that which may be of equal economic value to the advisor?

But most importantly for the application of these principles to this case is the simple fact that Arthur Lipper Corporation was an unaffiliated U. S. broker-dealer having no need to know of, or power to dictate the economic arrangements between IOS, its affiliated foreign management companies and the foreign investment companies. With respect to such economic arrangements, there is no evidence to suggest that IOS did not use the monies received, albeit indirectly, for the benefit of the foreign investment companies' shareholders. IOS made sales of the shares of the foreign investment companies. If increased sales of fund shares are accepted as a benefit to U. S. investment company shareholders, then a case can be made that there was a benefit to the foreign investment companies' shareholders. IOS also bore a portion of the cost of the communications system pursuant to the requirements of the NYSE. (A 119) IOS could have charged an additional full

commission for the placement of orders for the purchase and sale of all securities consistent with European banking and fund practice.[1/] IOS could have been entitled to a larger fee for rendering in depth multinational investment advice. IOS could have made full disclosure to the board of directors of the foreign investment companies. IOS could have received shareholder approval of the receipt of the cash, or its use to obtain investment research. The foregoing simply demonstrates that it is highly unfair to impose upon an unaffiliated broker, such as Arthur Lipper Corporation, the responsibility to police IOS' fiduciary responsibilities. And finally, what were the lawful fiduciary responsibilities of Mr. Cowett, and measured by what law since he was an officer and director of a Luxembourg trust (IIT) and two Canadian corporations (F.O.F. and Regent Fund)? We must agree with the admonitions given by Justice Frankfurter to the SEC in Securities and Exchange Commission v. Chenery Corporation, 318 U. S. 80 (1943), where the Court said (at pages 85-86):

> But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?

1/ See page 46 , *infra*, under the discussion of jurisdiction, where the practice in Europe is described with record references to the uncontradicted testimony.

III. THERE IS INSUFFICIENT EVIDENCE TO SUPPORT THE SEC FINDINGS

A. THE FINDINGS ARE NOT SUPPORTED BY SUBSTANTIAL EVIDENCE AS REQUIRED BY SECTION 25(a) OF THE EXCHANGE ACT.

The findings leading to the SEC's conclusions that Petitioners aided and abetted violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder are not supported by substantial evidence as required by Section 25(a) of the Exchange Act.

(1) <u>The SEC erred in concluding that the NYSE had "no jurisdiction" in the over-the-counter market</u>

The crucial SEC findings, namely that the NYSE had "no jurisdiction" in the over-the-counter market and that the over-the-counter market is a negotiated market (A 435) are unsupported by evidence in this proceeding. Lacking evidence, the SEC relies exclusively upon staff studies conducted during the period 1966-1968, particularly a study referred to in the SEC opinion as "Public Policy". The fallacy in the SEC's reasoning, whatever evidentiary value such studies may have, is that the references are tc broad general statements that are unrelated to the facts of this case. For example, while the over-the-counter market may well be one of negotiated commissions for non-NYSE members, the evidence in this case (A 167-69; 331; 279) demonstrates that NYSE members did not negotiate commissions on over-the-counter agency transactions, a fact the SEC later acknowledges (A 438). And the uncontradicted testimony of an official of the NYSE is that NYSE members could be and were challenged if they dared to deviate from the NYSE rates on over-the-counter transactions--this clearly establishes that the NYSE did consider that it had authority over its members in the over-the-counter market, <u>i.e.</u>, <u>de facto</u> if not actual jurisdiction.

The SEC's speculation that a lower commission rate could have been negotiated between Petitioners and IOS is based again on statements in Public Policy, not evidence in this record. (A 435). The crux of the SEC's reasoning is that commissions were negotiated in the over-the-counter market and not fixed--commissions on the NYSE were fixed, hence give-ups there were tolerated. This is clearly wrong as is demonstrated by the evidence in this record. For all practical purposes negotiation by NYSE members in the over-the-counter market and negotiation on the NYSE was the same. The negotiation took the same form--the amount of the commission-sharing.

The SEC overlooked evidence that there was no way in which Arthur Lipper Corporation could have justified to the NYSE charging a lower commission rate from a cost standpoint. Petitioners relied on undisputed evidence, ignored by the SEC, that in 1967 and 1968 Arthur Lipper Corporation would have been unable to demonstrate that 50% of the minimum NYSE standard rate was sufficient to cover its costs in executing over-the counter transactions. Thus, the SEC failed to consider the evidence that Arthur Lipper Corporation did a large amount of NYSE commission business for the same foreign investment companies and that in the early years of its existence Arthur Lipper Corporation derived a substantial portion of its business from IOS accounts. Therefore Arthur Lipper Corporation was particularly vulnerable to a charge that a significant reduction of over-the-counter commissions for the same customers was a blatant rebate of NYSE commissions. Moreover, the SEC failed to explain how Arthur Lipper Corporation could have satisfied the NYSE "cost test" in 1967 when the firm was just beginning in business and had incurred

large start-up costs involving, inter alia, an elaborate communications link between Europe and the United States to service these same customers. Arthur Lipper Corporation also incurred the expense of clearing the over-the counter transactions through Zuckerman, Smith & Co. for most of the period in question due to lack of facilities and/or excess capital to handle the transactions itself at a time when the industry was plagued with "fail problems". The "fail" situation was particularly severe with respect to over-the-counter securities and a firm had to have a wide margin of capital in excess of requirements, which Arthur Lipper Corporation did not have during most of the period, if it were to clear these transactions itself and take the risk that capital charges would be imposed when transactions failed to clear on the settlement dates. Finally the SEC staff which, after all, had the burden of proof, introduced no evidence that a single NYSE member firm was willing to execute an over-the-counter transaction on an agency basis at any commission lower than the applicable minimum NYSE rate.

In essence, then, the SEC has said we need no evidentiary record; we may rely on our staff studies in 1966-1968 to prove our case. Staff studies are secondary sources of evidence; worse yet, whatever educational value statements in such studies may serve, the general statements are unrelated to the facts of this case.1/

1/ The SEC cites staff studies on 12 occasions to support its findings. It is almost as if the whole case were a defense of these prior SEC staff studies.

The SEC stated that since IOS "did nothing in return for the income" it received, "[n]o extended discussion is required to demonstrate that this was a gross breach of fiduciary duty" by IOS and such a breach "was one of the evils that the Exchange Act sought to eliminate." (A 433) We believe that the Congress which enacted the Exchange Act would be surprised to learn that it intended to regulate the fiduciary relationships of foreign investment advisers to foreign investment companies. It is important to be mindful of the fact that Petitioners were found to be "aiders and abettors" and hence derivatively liable because of the alleged primary wrongful conduct of IOS. Again we are at a loss to understand the SEC's simplistic approach to the facts of this case. For example, for years several well known NYSE members, which were affiliated brokers of investment advisers to large U. S. investment companies, caused the advisers to have the investment companies execute the bulk of their NYSE brokerage transactions through the affiliated brokers who retained the full commissions. This practice was well known to the SEC. Since it was common practice on the NYSE to negotiate a 50% give-up arrangement, it must follow under the SEC's approach that such brokers and their advisory subsidiaries breached their fiduciary duties to the U. S. investment companies in violation of Rule 10b-5. No "extended discussion" is needed to establish that this situation is in economic reality no different from this case.

The affiliated broker "could have negotiated" a 50% reduction in the execution portion of the transaction and offset the remaining 50% against its subsidiary's investment advisory fee. Indeed, this example would seem to be a stronger case than the instant one where Arthur Lipper Corporation was an unaffiliated broker.

(2) Assuming arguendo that some disclosure should have been made to the directors or shareholders of the foreign investment companies regarding the NYSE commissions charged on over-the-counter transactions and the commission-sharing arrangements, Petitioners had no obligation or duty to do so.

The SEC may justify its tolerance of the practice described above with respect to certain U. S. mutual fund complexes using affiliated brokers on the ground that disclosure was made in the mutual fund's prospectus of the added compensation to the affiliated broker. However, even if this Court were to conclude that IOS was under a duty to disclose the receipt of the payments to the directors of the foreign investment companies and, perhaps, to their foreign shareholders, it is wholly unwarranted to require an unaffiliated broker to make such disclosures.

It should not be overlooked that the very nature of the commission-sharing practices involved here inherently contradicts the SEC's finding that there was inadequate disclosure, at least as far as Petitioners are concerned. A customer directed commission-sharing arrangement by definition involved an instruction by the customer to the broker to share a portion of his commission with a broker designated by the customer. Do we understand the SEC to assert that the broker is obligated to disclose to the customer what the customer instructed the broker? In this regard, at all times Petitioners dealt with a sophisticated officer and/or director of the foreign investment companies who as an attorney and U. S. securities law expert was familiar with and understood Petitioners' requirements for charging NYSE minimum rates and sharing commissions in accordance with industry practice. Petitioners

at all times recorded the transactions openly on the books of Arthur Lipper Corporation. As far as Arthur Lipper Corporation and Mr. Lipper were concerned, there was nothing about these transactions that required any unusual disclosure. They were not willing to risk expulsion by the NYSE or other disciplinary action by charging less than the minimum rate, and were willing only to share commissions with qualified members of the brokerage community.

The disclosures which the SEC would seemingly require of a broker extend far beyond the holdings of this Court. In Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) this Court held that a director in his capacity as a director owes no duty to insure that all material, adverse information is conveyed to prospective purchasers of stock of a United States corporation on whose board he sits. If a director owes no such duty, why should an unaffiliated U. S. broker in the United States owe any duty of disclosure to foreign investors in foreign investment companies operating under foreign laws whose standards of disclosure and duties with regard thereto are different from those in the United States? If such a duty is imposed, as the SEC seems to conclude, where does the duty end? How much does a United States broker-dealer have to know about foreign laws and standards before he dare undertake to effect transactions for foreign companies?

While this Court in Lanza, supra, stated that a director can be secondarily liable as an aider and abettor, a conspirator, or a substantial participant in a fraud perpetrated by others (479 F.2d at 1289), this Court nevertheless adhered to a scienter standard for the imposition of liability under Section 10(b) and Rule 10b-5 (479 F.2d at 1301-1302). This Court stated (479 F.2d at 1302):

> We recognize that participation by a director in the dissemination of false information reasonably calculated to influence the investing public may subject such a director to liability under the Rule. But it is quite a different matter to hold a director liable in damages for failing to insure that all material, adverse information is conveyed to prospective purchasers of the company's stock absent substantial participation in the concealment or knowledge of it. Absent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants. (footnote omitted)

Petitioners played no role in disclosures to the shareholders of the foreign investment companies, whether made in prospectuses, reports or letters. Thus they cannot be made responsible for any inadequacies of disclosure, if indeed there were any.

B. THERE IS INSUFFICIENT EVIDENCE TO REBUT THE PRESUMPTION OF INNOCENCE

In Section 10(b) and Rule 10b-5 cases the law of the forum state has been applied to matters involving the burden of proof. See Kohler v. Kohler Co., 208 F. Supp. 808, 827 (E.D.Wis. 1962) Aff'd., 319 F.2d 634 (7th Cir. 1963). Arthur Lipper Corporation's principal place of business was located in New York City and the transactions in question were effected from that office. Accordingly the law of New York should be applied with respect to the burden of proof.

In New York there is a presumption in favor of innocence and against the existence of fraud; indeed the presumption of innocence of fraud approximates the presumption of innocence of crime. Burstein v. Cohen, 188 NYS 812 (1921); Re Cushman, 95 Misc 9, 160 NYS 661 (1916). There is also

a presumption of honesty and fair dealing between the parties to a transaction. Wilhelm v. Wood, 151 AD 42, 135 NYS 930 (1912). Thus, the law presumes good faith, innocence and honesty. Therefore, the general rule is that fraud is not presumed or assumed, but must be proved by the party alleging it. Seymour v. Spring Forest Cemetery Assoc., 144 NY 333, 39 NE 365, 26 LRA 859 (1895); Chemical Corn Exchange Bank v. Wassung, 8 AD2d 788, 187 NYS 2d 548, aff'd 7 NY2d 337, 197 NYS 2d 169, 165 NE2d 184 (1960); Hathaway v. Harris, 1 AD2d 255, 149 NYS 2d 456 (1956); Nirenstein v. George A. Horvath, Inc., 286 AD 409, 143 NYS2d 833 (1955); Low v. State, 281 AD 309, 120 NYS2d 339, aff'd 305 NY 913, 114 NE2d 470 (1953); Cave v. Green, 281 AD 560, 120 NYS2d 865, aff'd 308 NY 754, 125 NE2d 109 (1955); Lynch v. Gibson, 254 AD 47, 3 NYS 2d 672, aff'd 279 NY 634, 18 NE2d 36 (1938); Lowendahl v. Baltimore & O. R. Co., 247 AD 144, 287 NYS 62, aff'd 272 NY 360, 6 NE2d 56 (1936); Waggoner v. Jageacks, 241 AD 324, 272 NYS 182 (1934); Kountze v. Kennedy, 147 NY 124, 41 NE 414, 29 LRA 360 (1895); Wakeman v. Dalley, 51 NY 27 (1872); Fleming v. Slocum, 18 Johns 403 (1820); Hathaway v. Harris, supra; Benz v. Kaderbeck, 241 AD 583, 272 NYS 558 (1934); Finsilver v. Still, 240 AD 87, 269 NYS 9 (1934). Fraudulent acts will not be presumed. Margrander v. Fox, 272 AD 788, 70 NYS2d 207 (1947).

It has been held in New York that where the evidence relied upon to prove fraud is equally consistent with innocence, that construction must be placed upon it which will exonerate the party accused. Aspell v. Campbell, 64 AD 393, 72 NYS 76 (1901); Freedman v. Norddeutscher, 22 Misc 2d 397, 199 NYS2d 709 (1959). Thus, if there is room for an inference of an honest intent, the proof of fraud is wanting. Spurr v. Hall, 46 AD 454, 61 NYS 854, aff'd Spurr v. Fisher, 168 NY 593, 60 NE 1120 (1920). Fraud cannot be founded

upon doubtful, vague, uncertain, and inconclusive evidence, or upon mere suspicion, supposition, or conjecture, either at law or in equity. Hollingsworth v. Napier, 3 Caines 182 (1805); Lynch v. Gibson, supra; Waggoner v. Jageacks, supra; Freedman v. Norddeutscher, supra; Kamaran v. Sidney Garage, 137 Misc 744, 244 NYS 337 (1930); Booth v. Bunce, 33 NY 139 (1865).

It is a general rule that fraud is negatived whenever it appears that the person accused has reasonable grounds for his belief in the truth of representations made. Kountze v. Kennedy, supra; Daly v. Wise, 132 NY 306, 30 NE 837, 16 LRA 236 (1892); Kiechle v. Circelli, 10 Misc 2d 1016, 169 NYS2d 885 (1958); Kramer v. Joseph P. Day, Inc., 26 NYS2d 734 (1941); Wheeler v. Robinson, 86 Hun 561, 33 NYS 921 (1895). Accordingly, where representations are honestly made in reliance upon information honestly acquired and in the honest belief in their truth, the person making the representations may not be held liable for fraud and deceit. Grill v. Driad Constr. Corp. 34 NYS2d 593 (1942); Kramer v. Joseph P. Day, Inc., supra, citing Kountze v. Kennedy, supra.

Here, where the SEC charged that Arthur Lipper Corporation should have charged the foreign investment companies less than minimum NYSE rates, it produced no evidence whatsoever of any NYSE member who did so or was willing to do so. Each NYSE member probably had, of course, reasons of varying importance for following the customary practice of charging minimum NYSE rates on over-the-counter transactions, but the primary reason in all cases was most certainly the risk of violating NYSE rules. Thus the SEC's "should have" theory had no evidentiary support in the record.

IV. THE ACTS COMPLAINED OF OCCURRED BEYOND THE JURISDICTION OF THE SEC AND IN ANY EVENT WERE THOSE IN WHICH PETITIONERS WERE NOT INVOLVED

The SEC's findings on Petitioners' arguments as to lack of jurisdiction miss the point. Petitioners never urged that "the charges against them have no real connection with the purchase or sale of securities." (A 440) Petitioners contend that there are three essential elements in a violation of Rule 10b-5: (1) use of U. S. mails or U. S. markets, (2) fraudulent conduct and (3) the fraud committed "in connection with the purchase or sale of any security."

The SEC apparently found that IOS defrauded both the foreign investment companies and their foreign shareholders. (A 440) It follows, however, that the shareholders could have only been defrauded in connection with their purchase of shares of the foreign investment companies, since a purchase or sale of a security is essential (See (3), supra) and these are the only securities purchased or sold by the shareholders. But there is no evidence that the United States mails or an instrumentality of interstate commerce were used in the purchase or sale of shares of F.O.F., IIT or Regent Fund. These funds' shares were sold and distributed exclusively overseas. Therefore, if the target of the alleged fraud was the foreign shareholders directly, the SEC has no jurisdiction since the element of jurisdictional means is missing.[1/]

1/ We assume the existence of the second element (i.e. fraud) solely, arguendo, and only for the purpose of demonstrating that a use of U. S. jurisdictional media is missing.

Hence, the SEC's finding that the jurisdictional media were used "in connection with the purchase or sale of a security" is necessarily limited to the finding that each of the foreign investment companies was defrauded in the purchase and sale of its portfolio stock because it paid Arthur Lipper Corporation too high a commission.1/ While we do not contest this use of the jurisdictional media, we shall demonstrate that, in so far as the foreign investment companies are concerned, the SEC lacks jurisdiction over another essential element listed above, namely the alleged fraudulent conduct.

This is not a case where foreign persons are acting to manipulate the United States securities markets2/; that would, of course, have a serious and direct adverse impact upon the United States investing public. The alleged fraudulent conduct involves measuring the fiduciary obligation of an officer and director of a Luxembourg trust (IIT) and two Canadian corporations (F.O.F. and Regent Fund). Moreover, two of these foreign investment companies do not even have a single U. S. shareholder -- IIT and Regent -- a fact the SEC chose to ignore. Although there may have been as many as 3,000 F.O.F. shareholders who were U. S. citizens (out of well over

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1/ The SEC's reference to shareholders of the foreign investment companies, therefore, must be considered as a derivative injury through their corporations.

2/ See in this regard extended discussion by the Supreme Court in Ernst & Ernst, supra reviewing the legislative and administrative history of Section 10(b) and Rule 10b-5.

100,000), these 3,000 bought their shares outside the United States prior to the IOS settlement order and did not accept the subsequent rescission offer required to be made to them by the order.[1] Having insisted that F.O.F. stay out of its jurisdiction, is it consistent or even rational for the SEC now to hold that F.O.F. (and IIT or Regent, for that matter) is somehow subject to the rules under the Securities Exchange Act of 1934.[2] Put another way, what possible policy of the federal securities law is served by this application to F.O.F. whose shareholders are overwhelmingly foreign, whose shares by SEC command could not have been sold to U. S. citizens, and whose remaining U. S. citizen shareholders chose not to accept a specific rescission offer required by the IOS settlement order?

Jurisdiction over the "fraudulent conduct" is lacking because the situs of the alleged wrongful conduct was outside the United States and did not have an effect one way or another on the integrity of the U. S. securities market.

An example would put Petitioners' argument in best perspective:

If a German bank sold a German citizen a U. S. security in Germany at an unreasonable mark-up, does the SEC have jurisdiction merely because U. S. jurisdictional means would be used to carry out the transaction?

1/ A 316-18

2/ The IOS settlement order precluded IOS (and the foreign investment companies) from engaging in any activities subject to the jurisdiction of the SEC. There has been no claim that the settlement order has been violated in this or any other respect.

Basic logic would seem to dictate that shareholders purchasing shares overseas in a foreign investment company are justified in expecting that U. S. law will not regulate the relationship between them and the officers and directors of their company. This is only proper because the fiduciary responsibilities in Europe have evolved under different commercial practices and customs. For example, it has been established without contradiction that it is the custom in Europe for a bank or other person placing an order to purchase or sell a security in the U. S. securities markets to charge the client a commission (A 127-30). The bank places the order with the foreign branch office of a U. S. broker-dealer and the client incurs the customary NYSE commission. Therefore the customer pays two commissions -- one to the bank and one to the NYSE member.

If we apply the European practice to the facts in this case, IOS, a foreign broker-dealer, would have been justified in charging the foreign investment companies a commission for placing the orders for the purchase and sale of securities with Arthur Lipper Corporation. Arthur Lipper Corporation was fully justified in charging and keeping the full NYSE commission. Thus, without any breach of "fiduciary duty" the foreign investment companies could have paid <u>two</u> commissions. Now, because Arthur Lipper Corporation and IPC shared one commission and IOS, who elected not to charge a commission,was the indirect beneficiary of the commission-sharing, the SEC announces that a violation of Rule 10b-5 has occurred.

Apparently, the SEC would have had to exonerate IOS (and hence the Petitioners) if there was "disclosure" to the fund shareholders. But what kind and how much disclosure was required and how was it to be conveyed? And once involved in the nature and extent of disclosure to

foreign purchasers of foreign securities in foreign lands, where does the involvement end? Does the SEC care to assume such responsibility even if it had the power? The SEC should not concern itself with these questions since its jurisdiction does not extend beyond the territorial boundaries of the U. S.

Section 30(b) of the 1934 Act provides:

> The provisions of this title or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title.

The plain meaning of this language, as it applies to the facts of this case, is that the provisions of the 1934 Act, including Rule 10b-5, do not apply to IOS. Thus, IOS did transact "a business in securities without the jurisdiction of the United States" and the SEC has not adopted any rules under Section 30(b) which would reach IOS's foreign activities.[1/] Moreover, the only error which the SEC can conceivably attempt to attribute to IOS -- failure to disclose to shareholders of the foreign investment companies the additional compensation paid to a subsidiary of IOS -- "occurred" (if anywhere) in the funds' prospectuses, none of which were delivered through the use of U. S. jurisdictional media. Since the SEC is without jurisdiction to regulate under the 1934 Act the obligations of IOS vis-a-vis shareholders of the

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1/ In the absence of a showing to the contrary, legislation is presumed to apply territorially. Foley Bros. v. Filardo, 336 U. S. 281 (1949); Blackmer v. U.S., 284 U.S. 421 (1932); American Banana Co. v. United Fruit Co., 213 U.S. 347 (1909).

foreign investment companies, Petitioners cannot be found to have "aided and abetted" a non-existent violator.

The only legitimate concern that the U. S. has in the relations between U. S. broker-dealers and their foreign customers is that the customers be dealt with fairly and honestly. Here Arthur Lipper Corporation charged its foreign customers the lowest possible rate consistent with universal industry practice and applicable regulations. No firm charged less to effect over-the-counter transactions. And Arthur Lipper Corporation honored the instructions of an extremely knowledgeable, duly authorized representative of its foreign investment company customers to share commissions with another broker-dealer consistent with industry practice. There was nothing unusual about the request to share commissions and no reason why Arthur Lipper Corporation should have questioned the instructions. Twelve other exchange members didn't object; they each shared commissions as instructed. Under these circumstances, all talk of "disclosure" is really beside the point. Arthur Lipper Corporation dealt with its foreign investment company customers honestly, openly and fairly -- all the Commission can reasonably expect and require of brokers within its jurisdiction.

In short, the SEC reached beyond its jurisdiction to impose its novel Rule 10b-5 theories on relationships that are essentially foreign, have no impact within the United States, and which by its own fiat specifically excluded from "conducting activities subject to the jurisdiction of the Commission . . . " <u>See</u> paragraph 1 of the IOS settlement order. (A 368-77)

Lack of subject matter jurisdiction is clear under the decisions in <u>Bersch v. Drexel Firestone, Inc.</u>, 519 F.2d 974 (2d Cir. 1975) <u>cert. denied</u>,

96 S. Ct. 453 (1975); IIT v. Vencap Ltd., 519 F.2d 1001 (2d Cir. 1975); and Judge Bonsal's decision in FOF Proprietary Funds, Inc., v. Arthur Young & Co., 400 F. Supp 1219 (S.D.N.Y. 1975), which in turn relied on Bersch v. Drexel and IIT v. Vencap.

In Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir. 1975), Judge Friendly expressed the issue in the following terms (519 F2d at 985):

> ...When as here, a court is confronted with transactions that on any view are predominantly foreign, it must seek to determine whether Congress would have wished the precious resources of United States courts and law enforcement agencies to be devoted to them rather than leave the problem to foreign countries.

After detailed discussion the Court concluded (519 F2d at 993):

> ...that the anti-fraud provisions of the federal securities laws:
>
> ***
>
> (3) Do not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses.

In F.O.F. Proprietary Funds, Ltd., v. Arthur Young & Co., supra, Judge Bonsal applied the teachings of Bersch and IIT to a case similar to that here presented, and concluded that subject matter jurisdiction was lacking. Plaintiff F.O.F. Proprietary Funds, Ltd. ("F.O.F.") was a foreign mutual fund which was part of the IOS complex. It allegedly purchased, in reliance on an offering circular $1,000,000 of Farrington Overseas Corporation ("FOC") Debentures which were guaranteed by FOC's parent, Farrington Manufacturing Company ("FMC"). FOC was a Delaware Corporation, while FMC was a Massachusetts corporation with its executive offices in New York City.

The offering circular in question, like the prospectuses of the foreign investment companies herein, expressly stated that the FOC Debentures had not been registered under the Securities Act of 1933 and were not being offered in the United States or to nationals or resident thereof. FOF alleged that it intended to prove that the allegedly misleading offering circular and related documents were drafted and reviewed by the defendants in New York, that some sales activity occurred in the United States, and that necessary corporate action relating to the financing was authorized by the Boards of Directors of FOC and FMC in the United States.

The defendants argued that there was no subject matter jurisdiction because the offering was intended to raise capital abroad, and F.O.F. was a foreigner residing outside the United States which purchased its Debentures in reliance on an offering circular distributed to it abroad, and which made payment abroad.

Agreeing with defendants, Judge Bonsal held (id at 1222-1223):

> The Court concludes that under the Bersch/IIT analysis Congress would not have intended the anti-fraud provisions of the Federal securities laws to apply to FOF Prop.'s purchase of the FOC Debentures and that accordingly this action must be dismissed for lack of subject matter jurisdiction.
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> ***
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> ...FOF Prop.'s purchase was 'predominantly foreign.' See Bersch, supra at [985]. FOF Prop. is a foreign company which acquired its shares abroad, purchased from a foreign company (Investors Bank), and purchased allegedly in reliance upon the offering circulars which apparently were distributed to it outside the United States. FOF Prop., being a Canadian company, incurred its losses outside the United States. Furthermore, the FOC Debentures were offered only to purchasers outside the United States and Canada and were issued to raise capital for foreign investment.

> Finally, under the Bersch/IIT analysis, FOF Prop. is a 'foreigner outside the United States' and accordingly may invoke the Federal securities laws only if it suffered loss from transactions involving securities under circumstances where 'acts (or culpable failures to act) within the United States directly caused such losses.' Bersch, supra at [993], IIT, supra at [1016-18]. The allegedly fraudulent conduct 'directly' causing losses to FOF Prop. (as opposed to conduct constituting 'mere preparation' to the fraud) consisted of the sale of Debentures and communication to purchasers of the allegedly misleading information, i.e., the distribution of the materially misleading offering circulars to purchasers and the misleading information transmitted at the closing, each of which occurred abroad. In the circumstances of this case, the drafting of the offering circulars and the underlying reports of FMC's (the guarantor's, not the issuer's) operations constituted acts in preparation of the fraud. Compare Bersch, supra; IIT, supra; cf. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed. 2d 539 (1975) 43 U.S.L.W. 4707 (U.S. June 9, 1955) The fact that the issuer, FOC, and the other defendants are American is of little independent significance. See IIT, supra at [1016]. Also, there are no allegations that FOF Prop. purchased its shares as a result of any of the sales activity by defendants in the United States.

As far as these Petitioners are concerned, the case for lack of subject matter jurisdiction is even stronger than it was in the F.O.F. case. As noted above, the Petitioners played no role whatever in the allegedly inadequate disclosures with respect to commission arrangements and committed no affirmative acts of any kind in the United States which contributed to the alleged inadequate disclosures. The sharing of NYSE commissions on over-the-counter transactions is not fraudulent; the failure to disclose such charges arguendo may be fraudulent. Thus, the only basis for complaint against Petitioners can be on the ground of inaction. As the Second Circuit observed in IIT v. Vencap, Ltd., supra at 1018, subject matter jurisdiction "does not extend to mere preparatory activities or the failure to prevent

fraudulent acts where the bulk of the activity was performed in foreign countries..." No acts by these Petitioners in the United States "directly caused" any losses resulting from purchases by foreign investors. Bersch, supra, at 993.

V. PETITIONERS WERE DENIED DUE PROCESS OF LAW

The administrative law judge, who was referred to by the SEC as "an adjudicator of long experience and great acumen" (A 453) had determined to bar Arthur Lipper Corporation from over-the-counter trading for 12 months and Mr. Lipper from the securities industry for 12 months. The SEC summarily dismissed this decision and barred Petitioners permanently. And the SEC's determination was based on the "aiding and abetting" theory whereas the administrative law judge had found Petitioners in direct violation of Section 10(b) and Rule 10b-5.

What then are the "public interest" factors which purport to justify the permanent bar of Petitioners? The administrative law judge stated (Doc. 340, R. 3758):

> Mitigating that portrayal, however, is the established fact that the customer-directed give-up practice had become embedded in the financial community and had not been judicially determined to be illegal during the years of respondents' violations, 27/ and the fact that Lipper relied upon advice of counsel. (emphasis added)

27/ In Moses v. Burgin, 316 F. Supp. 31, 57 (D. Mass. 1970), the court noted:

> No court has yet decided, and this court finds it necessary to decide, whether the customer-directed give-ups for the benefit of broker-dealers which were both customary and widely practiced before December 5, 1968 were lawful or unlawful.

The SEC ignored a fundamental fact--neither Arthur Lipper Corporation nor Mr. Lipper kept one penny of the monies alleged to have been "diverted" to IPC. There is no claim that Arthur Lipper Corporation was not entitled to 50% of the normal commission rate charge. Indeed, Arthur Lipper Corporation could have retained the full NYSE commission and the SEC would have had no ground on which to object. In other words, the foreign investment companies would have paid the same amount they actually paid and no one would have questioned the arrangement. It would therefore follow that when Arthur Lipper Corporation shared its over-the-counter commissions with IPC, the responsibility, if any, to offset fees payable by the foreign investment companies against the receipt of give-up payments lay with IOS, not with Petitioners. The SEC has not suggested how Petitioners could have compelled IOS to so offset fees. Nor has the SEC introduced evidence of a single unaffiliated broker-dealer who either compelled an offset against management fees or declined to execute transactions on behalf of registered funds whose management company refused to credit give-ups against fees. How then can the public interest require a sanction because Petitioners did not do what the SEC cannot show any comparably situated broker-dealer was willing to do?

In addition, it seems to Petitioners that the minimum requirements of due process involve the introduction of some evidence supporting the SEC's critical finding that the over-the-counter market is a "negotiated market" in the context of the factual record here. It is manifestly unfair to simply permit the SEC to rely on their own studies and staff positions as "evidence" of fraud.

Further evidence of the SEC's disregard for due process is the manner

in which oral argument was purportedly granted to Petitioners. Oral argument was granted on August 28, 1972. The decision for unexplained reasons followed the oral argument by three years. Three of the SEC commissioners who participated in the opinion (i.e. a majority) did not hear oral argument and were not even Commissioners on the date the argument took place. Accordingly, Petitioners were denied a de facto oral presentation. Petitioners do not urge this Court, however, to remand this case for oral argument because Petitioners believe this would simply prolong the extended ordeal already suffered.

Finally, since commission-sharing is no longer permitted, the decision in this case will have little effect on a more careful observance of the laws by the financial community in the future. Reversal of the decision by this Court will have no effect on the SEC's enforcement program. The sole function of this proceeding, therefore, is to punish Petitioners. The effects of past publicity on the reputation and standing of Petitioners stemming from the SEC proceeding has more than adequately served that purpose.

A businessman who follows in good faith the advice of well qualified counsel and adheres to industry practice should not be accused of aiding and abetting violations of Section 10(b) and Rule 10b-5. These proceedings should have been dismissed as a matter of law by the SEC and should be dismissed now by the Court.

Respectfully submitted,

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Dated: May 24, 1976

CERTIFICATE OF SERVICE

I hereby certify, in accordance with the Federal Rules of Appellate Procedure, that I have served two copies of the Brief of the Petitioners Arthur Lipper Corporation and Arthur Lipper III on the Respondent Securities and Exchange Commission by causing said copies to be mailed this date to the following named person and address:

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Securities and Exchange Commission
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Dated: May 24, 1976

APPENDIX

EXCERPTS FROM AMICUS CURIAE BRIEF
OF SEC IN TANNENBAUM v. ZELLER - NO. 75-7503

PAGINATION AS IN ORIGINAL COPY

its officers. Leaving aside problems of isolated individual insider transactions, the management of a typical corporation has an incentive to act in the best interests of the corporation because management is paid directly by the corporation and often has a substantial equity investment in the corporation. The individuals comprising an adviser to a mutual fund ordinarily exercise at least as much control over the fund as the internal management of a typical corporation does; yet, the adviser to a mutual fund is comprised of individuals who have their equity investments in a corporation external to the entity they manage and they derive their compensation from that external corporation. Thus, while the management of a typical corporation has the primary goal of maximizing the profit of their own corporation, the adviser to a mutual fund may be motivated primarily by a desire to maximize the profit of the advisory corporation, and this latter profit may, depending on the circumstances, be made at the expense of the mutual fund it manages.

It is not surprising, therefore, that the interests of the adviser and the mutual fund shareholders often conflict. Such a conflict is asserted as the basis of this litigation.

3. The Compensation System in the Brokerage Industry, and the Development of Reciprocal Practices and Recapture Techniques

This litigation arose as a result of certain practices which developed in the 1960's in connection with the fixed commission rate structure imposed by the securities exchanges registered with the Commission. Under that system, a broker which was a member of an exchange was compelled to charge an unvarying minimum commission of

X dollars on a 100 share transaction. If a customer wished to buy or sell 100,000 shares, he paid a commission of 1000X dollars. This system obviously did not reflect economies of scale; it did not cost a broker anywhere near a thousand times as much to execute a 100,000 share order as it cost him to execute a 100 share order. 9/

The problems created by this system did not become apparent until the 1960's, by which time mutual funds and other institutional investors had both grown and become more active in buying and selling large blocks of securities. Although, in the case of mutual funds, the commissions on these transactions were paid by the funds, the frequency of the turnover and the identity of the executing brokers were determined by the advisers. Most advisers used a few lead brokers possessing expertise in executing transactions involving large blocks of securities. Both the advisers and these lead brokers soon recognized that the fixed commissions paid by the mutual funds far exceeded both the actual cost and a reasonable profit to the executing brokers. With this realization came the development of numerous devices to recover the excess portions of the fixed commission rate.

The use to which the excess portion of these commissions should be put became the central question. Not suprisingly, advisers found a way to use them to their own best advantage. Most investment companies did not

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9/ Beginning in 1968, the fixed commission-rate system was gradually changed by the introduction, first, of a volume discount, and later, in successive stages, of negotiated rates for transactions exceeding and below certain sizes. Finally, in 1975, the Commission, by adoption of Securities Exchange Act Rule 19b-3, 17 CFR 240.19b-3, abolished fixed commissions entirely.

have their own sales forces to sell fund shares, but instead relied on the salesmen of many brokerage firms to sell fund shares. These persons were compensated out of the sales load paid by the new investor.[10] Advisers recognized that, if the excess commissions could be used to increase compensation of these salesmen, they would be inclined to promote the company's shares more vigorously, resulting in an increase in the size of the investment company and, in turn, in the advisory fee, which was based on the amount of the company's assets. In addition, advisers also desired to use the excess commissions to compensate another group of brokerage firms, which possessed no special execution capability but provided sophisticated and thorough research and statistical services.

The solution was to use the so-called "give-up" to compensate both of these groups of brokerage firms.[11] Advisers would instruct the executing broker to give up a portion of the fixed commission to one or more brokers who

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10/ "Sales load" is defined in Section 2(a)(35) of the Investment Company Act as "the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer. . . ."

11/ Give-ups had existed long before mutual funds and other institutions began to seek a way to use excess commissions. Basically, the New York Stock Exchange ("NYSE") allowed its members to give up a part of the commissions they earned to another NYSE member on any transaction executed on the floor of the NYSE. This rule was intended to cover the type of situation where, for one reason or another, a member could not service one of its customers and had to have another member do the execution. For example, the customer might have been in a place where his regular broker did not have an office, and so he used another broker who would then rebate part of the commission to the regular broker.

To distinguish this type of give-up from the type employed by the funds, the latter became known as "customer-directed give-ups."

provided research to the fund or sold fund shares. The use of give-ups was complicated by the fact that, while most of the fund's brokerage transactions were effected on the New York Stock Exchange ("NYSE"), many of the research and selling brokers were not members of the NYSE at that time, and thus were ineligible, under NYSE rules, to receive give-ups on NYSE transactions. The executing broker, therefore, often effected the brokerage transaction on a regional exchange, 12/ where both it and the research or sales broker were members. The regional exchanges also allowed give-ups, so that a dual member 13/ executing the order on a regional exchange could give up the excess portion of the fixed commission rate to a research or sales broker, which belonged only to the regional exchange.

When customer-directed give-ups were abolished, 14/ it was no longer possible for a fund to use an execution specialist for all of its brokerage orders and have that broker give up the excess portion of the fixed commissions

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12/ There are now 12 stock exchanges. Two of these -- the New York and American Stock Exchanges -- are often referred to as the "primary exchanges. Most of the remaining exchanges are referred to as "regional exchanges." See, 2 Securities and Exchange Commission, Report of Special Study of Securities Markets H.R. Doc. No. 95, 88th Cong. 1st Sess., at 911 (1963).

13/ A dual member is a broker-dealer which, in addition to being a member of the NYSE or American Stock Exchange, belongs to at least one of the regional exchanges. Id., at 223.

14/ In its Report to Congress on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d. Sess., 186 (1966) (hereinafter referred to as "Public Policy Report"), the Commission stated that it was giving "notice that it believes that exchange rules must be changed so as to preclude customer-directed give-ups." The NYSE responded to this and other suggestions and prohibited give-ups, effective December 5, 1968.

to research and sales brokers. Brokerage orders could, of course, be placed directly with these latter brokers, with the understanding that the commissions paid would cover both the normal execution charge and the extra research or sales services. This method did not prove to be practical, however, since many of the research and sales brokers had inadequate execution capability and there were far too many of them to reward in this way. Consequently, other techniques were devised for using commission dollars to reward brokers for sales and research services -- techniques collectively known as reciprocal practices, which did not require any execution capability of a specialized nature.[15/]

Instead of using these give-up and reciprocal devices to reward research or sales brokers, funds could use them to recapture the excess commissions for the funds' direct cash benefit, by arranging for a portion of the commissions to go to a broker affiliated with the adviser.

15/ In "regular-way reciprocity", for example, a mutual fund would approach a broker with execution capability and give it a brokerage order. However, since the executing broker could no longer give up part of the commission to the research or sales broker, the latter had to be compensated in another way. Thus, on a completely different transaction, the executing broker could name the research or sales broker as the "clearing broker," a broker which primarily handles the mechanical details of recording the executed transaction with the exchange, and thus share some of that commission with the latter because the rules of the exchanges allowed an executing broker to pay a clearing broker a specified amount of the commission.

When the technology of modern communications had developed sufficiently, the mutual funds did not have to rely on these techniques. Instead, they began to negotiate their transactions off the exchange floor. A fund would call a broker and say that it wanted to sell "x" shares of a stock. The broker would find buyers for the stock and tell these buyers to meet on one of the exchanges' floors to consummate the transaction. However, the fund could sometimes negotiate for the finding broker to "step-out" at the last minute and the fund would substitute a research or sales broker to do the actual execution and collect the commission. Although the latter might have no special execution capability, it did not need any since the transaction was already arranged.

The adviser, in turn, was permitted, under the rules of the exchanges, to reduce the amount of its advisory fee by the amount of profits, or a portion of them, derived from the rebates. For example, in the period before give-ups were abolished, the executing broker could be told to give up the excess commission to the affiliate. After give-ups were prohibited, the fund could use the affiliated broker for executing its brokerage transactions, or, if it chose not to, it could use any of the other reciprocal practices which did not require any execution of the fund's transactions by the broker that was to receive a portion of the excessive commissions.

4. <u>The Regulatory Environment</u>.

The Commission's response to this situation involved consideration of many complex factors. In a real sense, the debate, confusion and possibly conflicting views generated by the "recapture problem" were the result of the Commission's dual responsibilities under the Investment Company Act and the Securities Exchange Act.

Under the former, the Commission focused primarily on the effect of the allocation of brokerage commissions on mutual funds, their advisers and their shareholders. At the same time, however, the Commission was more broadly concerned under the Securities Exchange Act with the effect of brokerage allocation on the securities markets. From the latter perspective, the Commission was concerned with such matters as the appropriateness of fixed commission rates, the effect of such commissions on the structure of the securities markets, and the role of the Commission as an economic regulator.

As the Commission's thinking developed on these broader policy issues, and market characteristics continued to change and evolve, the Commission revised its prior positions to accommodate its market concerns. Undoubtedly

some persons regarded the Commission's later conduct as inconsistent with its prior positions on the narrower issues arising under the Investment Company Act.

This dual approach was apparent from the start of the Commission's statements on the recapture problem. In its Public Policy Report, 16/ the Commission described in detail the mutual fund reciprocal and give-up practices which were used to reward brokers furnishing sales and research services. It then pointed out that some mutual funds had created mechanisms for recapturing excess commissions for the funds' direct cash benefit, and that this course of action probably conferred greater benefits on the funds and their shareholders (Public Policy Report, p. 173). But, when the Commission discussed its legislative proposals for dealing with this problem, it pointed out (Id. at 185):

> "Since this report deals largely with mutual funds, it has discussed use of mutual fund brokerage as additional sales compensation primarily in terms of its impact on funds and their shareholders . . . . Apart from the purposes of, and impact on, such investors, the Commission is of the view that certain aspects of these practices, particularly the customer-directed give-up, impair the orderly and proper functioning of the securities markets themselves."

This same duality of approach is reflected throughout the Commission's response to the recapture problem. Thus, the release proposing Securities Exchange Act Rule 10b-10, 17/ a rule which, if adopted, would have required a fund manager to recapture commissions when it had means at its disposal to do so, also discussed a set of proposals submitted by the New York Stock Exchange. These proposals were to introduce a volume discount in brokerage commissions and to make several changes in NYSE rules to eliminate give-ups and other reciprocal practices because they created

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16/ See n. 19, supra.

17/ Securities Exchange Act Release No. 8239 (Jan. 26, 1968).

undesirable distortions in the market.[18/] As the Commission explained, Rule 10b-10 was intended to address this problem in a different way by removing the economic benefits derived by investment advisers from these practices. The Commission stated:

> "Proposed Rule 10b-10 represents an approach to the give-up problem which would not require significant change in the existing commission rate structure of exchanges nor require all exchanges to adopt a uniform approach to the question of give-ups and reciprocal business.
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> "While the New York Stock Exchange proposal and proposed Rule 10b-10 are not mutually exclusive on all points, the New York Stock Exchange proposal is, to a significant extent, an alternative approach."

Proposed Rule 10b-10 was later withdrawn; the Commission ultimately determined to follow the Exchange's alternate approach.

Similarly, while the Commission did suggest, in the context of the settlement of specific lawsuits under the Investment Company Act, that it would be appropriate for mutual funds to form brokerage affiliates for the purpose of recapturing brokerage commissions,[19/] it eventually concluded that such affiliations were not in the best interests of the securities markets. Thus, it promulgated Rule 19b-2 under the Securities Exchange Act to prohibit membership on exchanges by certain brokers affiliated with institutional investors. In its release announcing the effectiveness of this rule,[20/] the Commission again made clear the differing focus of

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18/ During the period commencing in 1968, when the Commission undertook a massive review of exchange practices, and particularly commission rates, the Commission directed much of its comments and proposed reforms to the NYSE. But its proposals were intended to, and in fact did, apply to the other exchanges as well. See, e.g., Securities Exchange Act Release No. 9950 (Jan. 16, 1973).

19/ See the amicus curiae memoranda filed by the Securities and Exchange Commission in Kurach v. Schlusselberg, 67 Civ. 93 (S.D. N.Y. 1969) and Gross v. Moses, 67 Civ. 4186 (S.D. N.Y. 1971).

20/ Securities Exchange Act Release No. 9950 (Jan. 16, 1973).

its comments on recapture. After reviewing some of its prior statements on the desirability of using brokerage affiliates to recapture commissions, the Commission stated that it was "difficult to see any inconsistency between the above position and Rule 19b-2, particularly when it is noted that the above position dealt with the conduct of fiduciaries in a given set of circumstances . . . whereas Rule 19b-2 deals with the proper membership structure of a central market system." 21/ It is possible, however, to read certain Commission statements intended to deal primarily with the Commission's approach to restructuring the securities markets as being intended to deal with the narrower problems of investment companies and their shareholders.

In summary, during this period of rapid changes in the securities markets, the Commission sometimes viewed the problems created by the customer-director give-up as a "mutual fund" problem, but, more frequently, and finally, it determined to deal with this practice as a problem of commission rates and market structure. Because of this dual nature of the Commission approach, it is difficult to find guidance -- in the context of this lawsuit, involving a specific fact situation raising questions of the fiduciary obligation of investment advisers -- in many of the Commission's general statements on the recapture problem. That does not mean that the history of the Commission's response to the recapture problem is unimportant; on the contrary, it illustrates the dynamic and constantly changing background in which the defendants' actions in this case must be judged.

21/ Id. at 95. Reflecting further consideration of these market structure issues, the Commission has since rescinded Rule 19b-2 in response to Congressional reports accompanying the recent amendments to the Securities Exchange Act. See, e.g., S. Rep. No. 94-75, 94th Cong., 1st Sess., at 67 (1975).

not intended "to provide a basis for the Commission to undertake a general revision of the practices or structures of the investment company industry." 45/ We believe that the language of both former Section 36 and Section 36(a) indicates that Congress did not intend to displace the discretion of the board of directors in decisions involving general policy questions relating to the overall structure of the industry. As noted previously, the decision on allocation of brokerage commissions was inextricably related to the general structure and practices of both the investment company industry and the securities markets. And, as we have shown, the structure and practices were by no means static. On the contrary, decisions had to be made in a constantly changing environment.

Thus, we believe that former Section 36 of the Investment Company Act and present Section 36(a) do not remove the type of recapture determination involved in this case from the discretion of the independent members of the board of directors. 46/ This conclusion

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45/ H.R. Rep. No. 91-1382, *supra*, at 37. The original bills in the 90th Congress leading to the 1975 amendments had simply authorized actions based upon "breach of fiduciary duty." The qualifying phrase "involving personal misconduct" was introduced in response to industry concerns that that original provision would give the Commission and the courts undue authority to require significant changes in the structure and methods of doing business in the mutual fund industry. Implicit in this was a desire to leave to the board of directors more discretion to determine whether such changes should or should not be made.

46/ We wish to stress that the mere fact that there is uncertainty in a particular area does not necessarily mean that liability can be avoided on the basis of an exercise of discretion by the board of directors. Fiduciary obligations still exist. Even in the area of recapture, certain matters are not within the board's discretion. For example, if the directors in this case, instead of deciding to use the excess brokerage commissions to pay for sales and research services, had directed the excess to be paid to the adviser's broker affiliate, there would have been no discretion to permit the adviser to retain the benefits. Fiduciary principles would have required that the excess commissions be returned to the Fund. See, Matter of Provident Management Corp., [1970-71 Transfer Binder] ¶ 77,937 (1970); Matter of Arthur Lipper Corp., Securities Exchange Act Rel. No. 11773 (Oct. 24, 1975).

CERTIFICATE OF SERVICE

I hereby certify, in accordance with the Federal Rules of Appellate Procedure, that I have served two definitive copies of the Brief of the Petitioners Arthur Lipper Corporation and Arthur Lipper III on the Respondent Securities and Exchange Commission by causing said copies to be mailed this date to the following named person and address:

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